

High Yield Bonds

An Investment More Profitable And Less Risky Than Stocks

An Investment U White Paper Report

By the Investment U Research Team

Five years ago, in the January 2000 Investors' Forecast Issue of The Oxford Club Communiqué, we issued a storm warning:

“We are at the peak of most likely the greatest financial mania that will ever be seen in our lifetimes and, quite possibly, the greatest ever witnessed.”

The January 2001 Forecast Issue advised readers to seek shelter, batten down the hatches, and let the storm blow over.

The results speak for themselves as our recommended “Bulletproof Portfolio” weathered the storm, posting positive returns in a down year for the overall U.S. stock market.

Then, in our 2002 Forecast Issue, we maintained a similar stance:

“We simply [didn't] see the V-shaped economic recovery that most of Wall Street is yammering about.”

So how does the weather look now, five years later? It appears the storm has largely passed, but the sky is still cloudy enough to keep us from bolting back into the market with little regard for risk.

With the history so consistent in this asset class, we set out to find a greater measure of safety and significant returns to boot – the Holy Grail, right? Well, not quite, because this type of investment actually exists...

The Investment Class We're Talking About Is High Yield Bonds

And as we dug a little more into the recent performance of high yield bonds, we became that much more excited about its potential... We found that during the great bull market of the 1990s, the high yield bond class trounced the overall stock market by 37.5%. More recently, over the past three years, it has beaten the Dow Jones Industrial Average by 125%. And it bettered the Nasdaq by 371%. And from what we can tell, over the next 12 months, it's going to get even better.

The New York Times reported that America's top money manager, Bill Gross, who oversees the gigantic PIMCO fund and manages a total of more than \$464

billion, is known to have shifted as much as 15% of his own personal retirement savings to the high yield bond investment class. When he makes a move like this, people take notice. He's one of the most successful investors in the world...

** Business Week recently called Bill Gross "the 'guru' everybody turns to for direction when the market is rattled – or when it rallies."*

** Barron's reported that in three decades as a money manager, Gross has averaged double-digit annual returns, with only three down years (his biggest loss was 3.36% in 1994).*

** Mutual Funds magazine called him, "possibly the best fund manager in the country."*

Gross recently predicted that high-quality assets in this class should continue to perform well – but cautions that some players in the market (such as the government and its securities) should be expected to keep up.

He explained that investors don't always get the straight story from advisors or from the government. He says that "as with most fairytales, the wicked witch lurks."

And right now this investment "giant" is pointing to the exact same investment that we are recommending in this report: high yield bonds, which we expect to be at least 10 times more profitable – and less risky – than any individual stock or stock mutual fund you can buy today.

In this report, we'll also share two very important ways that you can take advantage of high yield bonds as an investment strategy. And it should be enough to satisfy even those investors with a higher tolerance for risk.

The End of the Run for Treasuries

Before giving you the details on high yield bond opportunities below, we'll first lay out some fundamental and background information that led both The Oxford Club and one of the world's greatest investors to the same decision about this asset class: That it's the best opportunity available to you today for market-stomping returns with less risk.

We'll begin with a look at today's market conditions and why they're indicating that the 23-year bull market in U.S. government bonds has run its course... and why that's important for this investment.

The 23-year bull market in U.S. Treasuries certainly was impressive. The successful, two-decade assault on out-of-control inflation that primarily fueled this run was no doubt a justifiable reason to continually bid up Treasuries.

But with long-term interest rates having steadily fallen from a painful 15.8% in 1981 to less than 3% in 2004, and inflation nearly non-existent today, investors have to start wondering how much further rates can fall. After all, the U.S. Federal Reserve's aggressive lowering of interest rates has brought the Federal Funds' rate down to 3%, today, up modestly from the decades-long record low of 1% only two years ago. Chances are slim that rates will be any lower in the near term. The current 3% rate is not very likely to again drop down to the 2003 level in our opinion.

The market has had a lot to digest: That includes the bursting of the U.S. equity bubble along with all its consequences, not to mention the flood of headline-grabbing mega-bankruptcies and corporate scandals only two to three years ago – which continue even to today, but not as much on page one.

All the while U.S. government bond enthusiasts certainly have grown more excited during this latest stretch. Global economic uncertainties, a confidence-denting mid-decade trend in the continuing bear market, even despite the 2003 secular rally. This is a prolonged U.S. equity bear market characterized by ever-increasing warnings of deflation... an aggressive Fed continuing to use interest rates to drop-kick the economy... and geopolitical instability (including terrorism and war). All have prompted many investors to flock to the safety and security of U.S. government bonds.

Taking the Broader View: The Economy on the Mend

But let's take a step back for a moment and look at what's changing today. Signs abound of the U.S. economy slowly mending itself, which is not to say a V-shaped recovery is imminent. Just that such an environment portends well for some degree of economic recovery, to say nothing of the mini-rally that's gone on since before the 2004 election – the latest leg in a series of mini-rallies we've seen for three years.

Whether this means a continued appreciation in the equity market or merely a flat market is impossible to predict. At any rate, if an end to the equity bear market is truly here, that only takes away one factor currently supporting U.S. Treasuries. Bill Gross predicts a 3% to 4.5% yield on 10-year nominal Treasuries into the near future; but this only approximates inflation. Gross draws a parallel between U.S. Treasuries and the vulnerable "king" of U.S. debt securities, stating he is "content to acknowledge our reigning King's clothes, the poor quality of the stitchery, and the partial exposure of his bare bottom..."

Perhaps even more significant than Uncle Sam's bare bottom in terms of yields and inflation, the ever-increasing warnings of outright deflation (i.e. falling prices) may prove to be one of the most – if not the most – important considerations for investing in U.S. Treasuries. The deflation warnings have been growing louder

and louder in recent years, further fueling the U.S. Treasury bull market and justifying ever lower long-term Treasury yields. Long-term bonds benefit during an era of low inflation, and even more so in a deflationary one because low inflation doesn't erode the value of future fixed income payments by much, while deflation actually boosts their value.

U.S. monetary policy confirms what we suspect. As the debt bubble continues and as the Fed prints more and more money, there will be but one beneficiary: long-term high yield bonds.

So what's this all mean for investing... and more importantly, for the opportunity before us today?

Mighty Pricey Bonds

In the absence of deflation, U.S. government bonds look expensive. Even if Treasuries prove not to be overvalued currently, they are most definitely fully valued.

With the U.S. Federal Funds rate only two points off a 41-year low only two years ago, we correctly predicted that the next direction for rates would be up. The result: an equally predictable drop in U.S. government bond prices. And without any capital gains to boost performance, today's paltry Treasury yields don't offer much to get excited about, even given the increased Federal Funds rates we've seen lately.

While war and terrorism most definitely scare investors and business decision-makers, it is the other fundamental factors above that matter most. No one can accurately predict further terrorist attacks or the possibility, outcome and side effects of any war(s). But recent history has proven such acts as more blips than cliffs in the long run.

There's no doubt that the signals boosting U.S. Treasuries in this final stretch of their bull market have been valid. But the run has gone too far as some of the supporting legs no longer remain.

Interest rates may not rise rapidly from here due to the soundness of the other supporting factors, but at 3%, they seem to have found their support level. Our outlook is for a very gradual rise in interest rates, thus falling Treasury prices.

Even Bill Gross, the world's biggest bond investor, recently admitted that Treasuries look "bubbly." He stated only three years ago, "With U.S. Treasury yields already near rock bottom, the odds favor bear market Treasury trends if only because when yields can't go down they must eventually go up." He was right. Now, while maintaining the belief that rates will remain consistent he is dubious about any substantial future improvement in Treasury yields.

Don't Expect Miracles from Stocks Either

With our view that it's time to move out of safe-haven U.S. Treasuries and into a recovery play, why not focus on stocks? The irony in this strategy stems from the notion that "this time it's different"... the exact same sentiment that helped to inflate the U.S. equity bubble in the first place when investors were clamoring on about the "new economy." But the recovery process really is different this time.

Why so different? After such a monstrous financial bubble, which certainly doesn't happen often, the economy has much to mend, having so many facets of the market thrown out of kilter. Consider the mania-driven gross misallocation of resources, overindulged corporate capital spending, skewed valuation benchmarks, overextended (debt-laden) consumer and corporate balance sheets, a bloated current account deficit, etc.

What exactly made the U.S. financial bubble of the late 1990s so extreme and rare? A multitude of random, highly influential factors simultaneously and coincidentally converged: an extraordinary technological revolution combined with the post-Cold War rejuvenation of globalization and capitalism among a wider sphere of countries. Other factors included the defeat of inflation, the spread of a U.S. equity love affair, a downward re-rating of equity risk, deregulation in various industries, the ease of capital raising/creation via a much more sophisticated capital market, inflated corporate results throughout the decade that were only revealed in 2001-02... and the list goes on.

The crest of this tidal wave peaked with the development of a crowd hysteria that veered so far from reality as to seem utterly absurd in hindsight. Let's not forget the dotcom bubble, not to mention Enron, among others. So it's not unusual that the economy and the financial markets in the U.S., as well as globally, have been behaving nothing like the typical post-World War II business cycle, which invariably bounced back after a relatively quick recession. The numbers are momentarily distorted as well by 9-11, but in the long term the pattern makes sense.

For instance, who would have thought the U.S. stock markets would decline an almost unprecedented four years in a row, an event not seen since the infamous Great Depression of the 1930s?

The point is that we're in uncharted territory. Though it has been surprisingly resilient considering all the body blows it has absorbed in the wake of the popped bubble, the U.S. economy has yet to thoroughly prove itself in its ability to fully and smoothly address not just all the imbalances built up during the bubble years but also the recent heightened threat of terrorism and war(s). So here we are more than five years after the bubble burst and two years beyond the national

election, and we're still assessing the damage and licking wounds. We'd expect things to settle down and pick a direction by now, but unbelievably, the market – due to complex combinations of reasons – is continuing an exceptionally long-term correction.

To Grow or Not to Grow

In this post-bubble correction process, the U.S. economy must deal with a number of factors, such as a staggering loss of income and wealth, damaged investor and business psychology, bloated business models, an extremely low capacity utilization rate, weak corporate pricing power, record-breaking behemoth bankruptcies, and a loss of trust due to corporate scandals.

A full-blown expansion has yet to ensue as would be the case by now in the “typical” post-war recovery with its release of pent-up demand. Nevertheless, sparks of a recovery have been flickering, with more to come later this year and in 2006, we believe. And for good reasons...

The U.S. economy is advancing modestly at best, though clearly not strongly enough to generate a big surge in jobs. The majority of jobs created have been in low-paying retail and healthcare sectors, while we continue losing higher-paying wages to overseas competition. But jobs are jobs, and gradually the picture is improving. Growth in baby steps may be an apt description. But the dreaded “double dip” back into recession hasn't materialized either as many trumpeted in the darkest hours last year. The light at the end of the tunnel may be faint, but at least we're seeing a glimmer.

Such a timid economic environment may hold back stocks for some time to come.

More Deflation on the Way?

We refer once again to Bill Gross, the world's biggest bond investor, who recently constructed a model to assess the level of U.S. stock valuations. In his model, he compares valuations for bonds and stocks using corporate bond yields versus the earnings yield (the inverse of the P/E ratio) for the S&P 500. Gross's model takes into account core earnings – the commonsense valuation tool that's less hype-prone than pro forma earnings – and finds that stocks are still largely overvalued when compared to corporate bonds.

Here's the upshot: The late-1990s overvaluation has yet to be fully corrected. Don't look to over-10,000 Dow numbers to judge stocks. As long as the industrials list is tinkered with and that weighted average goes on, the Dow's results don't tell the real market story. So investing in stocks as a play on a U.S. recovery is less persuasive if you look at the numbers realistically.

The imbalances of the bubble must first be purged or corrected before a healthy and robust recovery takes place. The road is likely to be a long and bumpy one as our bloated overweight market economy continues its painful dieting and exercise program. Unfettered market forces – which the U.S. largely enjoys, especially compared to the sclerotic economies of Europe and Japan – will undoubtedly work their magic in flushing out the bubble debris, those excess calories of a bloated market left alone for far too long.

But such a process takes time – longer than widely expected – and we must be patient. For all of these reasons, savvy investors realize they need to pinpoint the optimal way to capitalize on a slowly recovering U.S. economy without assuming too much risk. The answer is high yield bonds, the perfect transitional investment.

Petty Name-Calling: “Junk Bonds” vs. “High Yield Bonds”

Of course, we wouldn't want to be accused of misleading readers about exactly what type of asset we're dealing with here. The label “high yield bond” certainly is apropos, given the juicy level of interest rates paid out by these bonds. But this asset class underwent a marketing makeover, if you will, many years ago.

The old moniker “junk bonds” was their original name upon entering the U.S. capital-market scene in the mid-1980s. But as you can imagine, “junk” didn't quite garner the image that the financial community wanted to project, hence the new name “high yield bonds.”

Though such a re-labeling shouldn't be viewed as Wall Street trying to pull the wool over investors' eyes, this asset class is most definitely legitimate and, just like any other investment, has its good years and bad. The “junk” label just seemed to be an image handicap worth... well, junking.

Yet if some insist that “high yield” bonds should be called “junk,” then should stocks be labeled “trash” given their dismal performance between 2000 and 2005? In other words, image is in the eye of the beholder or, putting it another way, risk is in the eye of the profiteer. Of course, relative performance and timing matter most.

Consider the facts. Actual defaults have run under five percent over the long term, so risks are very low. When you look at the rate of corporate bankruptcies in the U.S., you have to wonder whether investing in equity is even safer. And even if high yield bonds do go into default, investors get 44 cents on the dollar on average, so default does not mean a total write-off. You're likely to get some of your money back even in the worst case.

The bottom line is that high yield bonds – just like any other asset class – should be assessed based on what they have to offer, their realistic risk level, and the

current economic environment... not on their name. These bonds are what they are, regardless of the label. So let's move on and review some fundamentals.

The Case for High Yield Bonds

Looking back over the past two decades, U.S. investors have witnessed or experienced two equally and mightily impressive bull markets in U.S. stocks and Treasuries, the former culminating with a manic bubble in early 2000 and the latter – in our humble opinion – ending in 2003. Since then the markets have floundered and cannot seem to jump out of the doldrums.

In the above analysis, we've stated the case that Treasuries, with their rock-bottom yields, look tapped out and likely to steadily, but slowly, flatten out in the coming months and years, while U.S. stocks look set to spend more time than usual stabilizing and catching their breath before once again resuming their climb.

Given such a scenario, where do investors now go for gains? The idea of reaching for as much yield as possible has been slowly gaining ground. So it follows that the better value of high yield bonds, when compared to stocks and government bonds, is gradually capturing investor attention.

High Yield Bonds Offer the Ideal Characteristics that Investors Will Increasingly Crave

Keep in mind: high yield bonds should be viewed separately from their investment-grade cousins and even more so from their distant relatives: U.S. government bonds. Not only does the risk level among these different bond classes vary, but the variables that affect their pricing differ as well. You could say that they're a bond of a different color.

The starting point of the risk spectrum begins with U.S. Treasuries, which are vetted with safe-haven status given the unlikelihood of the U.S. government defaulting on its bond obligations. Next in line are investment-grade corporate bonds followed by high yield bonds.

In fact, high yield bonds are more akin to a conservative equity play than a traditional, low-risk bond. Yet while high yield bonds are less volatile than stocks, they have the capacity to generate the kinds of double-digit returns expected from equities. So what determines whether a company's bonds fall into the high yield category?

Independent rating firms, such as Moody's and Standard & Poor's, periodically evaluate the financial strength of companies to determine their ability to meet interest payments and pay back any principal due. Usually, only several hundred of the strongest corporations qualify for investment-grade status (extremely low

risk and of the highest quality) with the remaining companies categorized, to varying degrees, below investment grade. They are, literally, graded on a curve. Bonds are considered high yield when they're issued in the category below investment grade.

Generally speaking, companies comprising the high yield category may be less established than your typical household brand name; have a less than bulletproof balance sheet; and may have suffered a debilitating financial setback at some point. What's more, high yield bonds may not be secured by much in the way of assets, so recovery rates (in the event of liquidation) may prove much lower compared to investment-grade bonds.

The History on High Yield Bonds: Where Have They Been?

Before furthering the case for high yield bonds, let's first look at historical performance, which reveals the all-too-common cyclical pattern of this asset class. Since inception in the mid-1980s, high yield bonds have rewarded investors with mid-teen annual returns during up markets, and have held steady with flat returns during the toughest of bears.

A Look at the Fundamentals

As already mentioned, company fundamentals along with general economic trends matter more than the level of interest rates when assessing the attractiveness of this asset class. So how do things look today? Great for high yield bonds.

Business profit margins have stabilized, and profits are tentatively beginning to rise. The lack of corporate pricing power continues to be a hindrance, but stronger productivity gains and the considerable, ongoing cost-cutting drive is starting to offset this obstacle. Such cost-cutting efforts should slowly but surely boost profits going forward.

Corporate Cowboys and Their Permissive Auditors

With the mushrooming of corporate scandals and their aftermath in the last few years, executives are under the microscope more than ever, as Sarbanes-Oxley tightens the noose around the necks of the corporate cowboys and their permissive auditors. This has prompted more cautiousness with any expansion plans. One casualty has been mergers-and-acquisitions activity, which increasingly has been revealed as a losing, value-destroying strategy anyway – so this drop-off may be permanent. And the boom-time habit of share buybacks has also slowed down. Altogether, the result has been a sharp rise in corporate cash flow.

With profits and margins beginning to recover and more corporate cash being generated, one would normally expect such an event to serve as the stage-setter for a boost in capital spending. But with geopolitical uncertainties, the ongoing bubble clean-up, substantial unused capacity, still relatively high indebtedness, and the absence of any possible release in pent-up consumer demand, companies seem to be hoarding their cash and holding back investment.

Many hopefuls anticipated that a new surge in capital spending would pick up the slack once the U.S. consumer tires. Such hopes are now receding as little suggests a return to dynamic investment in the near term. Rather than aggressively expanding, efforts are concentrated instead on cutting down the substantial debt built up during the debt-happy bubble years. A full-blown, swift expansion cannot ensue in such an environment.

Today's Real Corporate Climate

In essence, what we have is a corporate climate where profits are merely attempting to recover, balance sheets are being de-leveraged, and solid cash flows are being hoarded rather than used to pump up capital spending – all of which improves the ability of companies to service their debt. Such a climate bodes better for high yield bonds than stocks. This is bolstered by low default rates, reasonable post-default recovery, and continued stock doldrums.

An economy can perform well enough without a booming V-shaped recovery. Again, the beneficiary in such a scenario right now would be high yield bonds rather than stocks, as the performance of the high yield bond is based on the ability to meet debt payments while stocks depend on solid profit growth.

Good investing,

The Investment U Research Team

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